

# WHAT IS YOUR BUSINESS WORTH?

By Bradley G. Marlor

At first blush, the question of business worth may seem superfluous; you're in a business building mode, not business selling mode. Sound familiar? You're not alone. The knee-jerk reaction of most business owners, is to think about value only when they contemplate selling. Understanding what your business is worth, or how it is valued in the market, however, may offer you insights on building greater value today for a better return tomorrow.

## **The Myth of the Multiplier**

Obtaining a value on your business is not akin to evaluating the worth of your 1994 Lexus. Although there are many automobiles traded that are virtually identical, businesses rarely have quantitative features that substantially match. Uniformity is scarce. And so are comparables in the market place. If you use a multiple of earnings or sales, you invariably leave out the unique features that make your business valuable. Clearly the only way to know what a business is worth is after the business is sold in a market situation.

But if you don't anticipate selling your business, you still may find yourself in the position of needing a formal evaluation. Here are just a few examples of businesses needing formal valuations:

- \* Buy/Sell Agreements between partners /shareholders
- \* Divorce proceedings
- \* Loss of an Equity Partner (through death or planned departure)
- \* Insurance purposes
- \* Unexpected merger or acquisition offer

In the case of buy/sell agreements, or the departure of a partner, many partners agree at inception to provide exit options based on the current worth of the company. Unless that current worth has a formal price tag, or straightforward calculation, plan on angry partners, and attorneys with smiles. Divorce proceedings that include splitting the value of the business nearly always end up in dispute and court. The best way to resolve the argument is to have a formal evaluation performed, that all parties agree to along the way.

Insurance providers will commonly ask the value of corporate stock for liability or other insurance needs. To be properly insured, accurate, substantiated figures should be submitted. Finally, if you are fortunate enough to be attractive to a prospective buyer, without having marketed your company, you may want an outside opinion as to the size, structure and terms of a potential purchase agreement.

### **Private vs. Public**

Privately held companies deliberately minimize or disguise their bottom lines, for tax purposes. Although the practice is common and (presumably) legal, consider publicly held companies. CEO's across the fortune 500 community are in a constant search for ways to bolster their earnings. Why? Because they know what earnings do to value in "their" valuation market. They receive a rule-of-thumb value on their company every time wall street closes trading for another day. Simply multiply shares outstanding by the trading price of the companies stock and presto!, you know what that company is worth. Some of those companies are traded at ten to fifteen times EBIT (earnings before interest and taxes).

But if your business is not fortunate enough to have access to public valuation via stock trades, what methods are used to put a current figure of worth on your company? Although there are numerous valuation methods available, a select few are always considered when valuing businesses, and are most commonly used in the valuation profession. The following three methods, or variations on those themes are standards in the industry:

- \* Asset Approach
- \* Income Approach
- \* Market Comparison Approach

## **Valuation Approaches**

Of the three approaches, the asset approach is the most straightforward. The business is valued based on the current value of the assets. The assets of a going concern are usually substantially higher than assets valued for liquidation purposes. This approach is effective for companies with heavy assets (such as a manufacturer), whose cash flows are marginal. It is not an effective approach for companies with high intangibles (such as high-tech or computer industry), unless there is a known market for the intangibles. It is not a good approach for companies with minimal assets (such as service related or distribution companies).

The income approach is the most widely accepted approach for valuing companies. The premise being that the best barometer of value is derived from the predictability of the income stream. Consistency and constancy, along with the size of cash flows will qualify companies for the highest values. Remember, values are a consideration of worth, not to the current owner as much as to prospective owners. The income approach is valid particularly when the equity stream or economic stream being derived from the assets, is more valuable than the assets themselves.

The market comparison approach is valid under limited circumstances. The issue with this approach is commonality. Since there is little uniformity, in businesses as previously discussed, this approach will only work when many comparable factors are present. Franchises do qualify quite well for valuations using this approach. The franchisor in fact will typically keep fairly accurate information on franchise sales. Professional practices and service related companies also can potentially be valued with the market approach. Keep in mind however, that trying to find a like-kind business in the same industry, about the same size, with relatively the same kinds of return is at best difficult. Most businesses are privately held, so even if you do match up with like-kind businesses that have traded hands, chances are there will be no information available on the transaction.

## **A Clear Picture**

The only rational way to make some sense out of the wide variance between privately held and publicly held companies is to standardize the information. Recasting the privately held financial statements to appear as a publicly held financials, would appear to be the optimum method. The whole point of recasting is to provide a clearer picture of the financial operations of the company without the personal perks of the owner. Examples of discretionary perks that typically get recast would include auto and travel, insurance, retirement mechanisms, salaries paid to non-productive staff (i.e. spouse and children), and any non-customary or one-time expenses, or expenses that don't directly impact the operation of the business.

Any revenue not shown on the income statement that the owner insists is being generated (wink, wink), should not be used in determining the worth of that entity. When there is an intimation made that monies, other than what is being shown on the financials, is contributing to the owners cash flow, professionals distance themselves very quickly from the owner and the business! Business owners who skim cash find it very difficult to get a credible appraisal; the valuation can only be substantiated on verifiable information.

## **The Final Analysis**

At some point in the life cycle of your business, knowing what the current value is will be necessary. The optimum approach used will be dependent on the type of business and its viability as a going concern. Consult with professional services providers to formulate a basis for the valuation. If you are considering the eventuality of transferring your business to new owners, reflect on the valuation approaches that will make your business the most attractive. In the long-run, the worth of your business is dependent on the future value you or someone else derives from it.